

March 18, 2005

The President's Advisory Panel on Federal Tax Reform  
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Dear Advisory Panel,

This letter contains comments per the “Advisory Panel’s Request for Comments #1” as posted on February 16, 2005.

As requested, our comments at this time focus on the goals of reform as well as aspects of the tax system that are unfair.

Sincerely,

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Submitted by the Center for American Progress, Washington DC, on March 15, 2005.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe Americans are bound together by a common commitment to these values and we aspire to ensure our national policies reflect these values.

## **Aspects of the tax system that are unfair**

Recent tax policy changes have moved our system away from the basic principle of fairness. This can be most clearly seen in two areas: first, the tax share has shifted away from those who can best afford to pay and onto the middle class; and second, corporations have largely been able to avoid their obligation to pay taxes, often by shifting operations overseas. The result is an increased reliance on a regressive payroll tax, which falls most heavily on lower- and middle-income taxpayers. Furthermore, income from accumulated wealth is given preferential treatment over income from work in the form of salaries and wages.

During the last 50 years, corporate taxes have fallen from 30 percent of federal revenues to less than 10 percent today. At the same time, the federal government has become increasingly reliant upon regressive payroll taxes, which made up 10 percent of federal revenues 50 years ago and over 40 percent last year.<sup>1</sup> The federal income tax (including taxation on income from wealth) is a more progressive form of taxation; however, it has been scaled back as a funding source over the past few years. These trends are not in line with our history of progressive taxation and the tax reform panel's goal of creating a tax system that "share[s] the burdens and benefits of the Federal tax structure in an appropriately progressive manner."<sup>2</sup>

### **Tax Shifts**

There is little doubt that the benefits of the recent Bush tax changes were dramatically skewed toward benefiting the wealthy to the detriment of the typical American

worker. In 2004, households making more than \$1 million received an average federal income tax cut of \$123,592, while the average change for those in the middle 20 percent of income was only \$647.<sup>3</sup> Increases in the deficit that resulted from these changes mean that these taxpayers will face higher taxes in the future—which will offset many, if not all, of the reductions for middle-income taxpayers.

*The tax panel and policymakers need to consider the distributional implications of any proposed reform plan. In particular, a full set of distribution tables showing the tax implications of reform on: 1) various income distribution percentiles, as well as 2) breakdowns by income and wealth classes, must be announced, debated, and fully considered.* The Treasury Department should be urged to again produce these tables, which was once standard practice within the department.

### **Income from Wealth**

By focusing many of the tax benefits on passive income from investments, President Bush offered individuals in the top 1 percent income bracket a whopping 34 percent of the benefits from the irresponsible tax cuts.<sup>4</sup> As a result, Bush's tax changes reduced the share of federal taxes paid by the top 1 percent of income earners, while increasing the share paid by the middle fifth of workers. These changes thus shifted the tax code to reward wealth at the expense of work.

Efforts to make recent tax changes permanent and eliminate estate taxes and taxes on capital gains and dividends would further lighten the tax burden of the wealthy and make the federal government's revenues more reliant on middle-class families, making the tax

system even less progressive.

As noted above, the system has become increasingly reliant on the payroll tax, one of the most regressive components of our tax system. It imposes an effective tax rate that is four times larger for middle-income workers than for those in the top 1 percent. The payroll tax only accounted for 23 percent of federal revenue in 1970, but now makes up an astounding 40 percent.<sup>5</sup> The increasing reliance of the federal government on this regressive source of revenue makes the tax system even more unfair.

### **Corporate taxation**

While the middle class is paying a larger share of federal taxes, major U.S. corporations are paying less and less. Though the corporate income tax rate structure maintains a degree of progressivity, it is riddled with loopholes that allow corporations to avoid paying taxes. A recent study found that 82 of the nation's largest corporations paid zero taxes in at least one of the last three years, and 28 corporations did not pay taxes in any of the years despite generating pre-tax profits of \$44.9 billion over the period.<sup>6</sup> Part of the increase in corporate tax avoidance is explained by an explosion in the shifting of investment and profits overseas. Profits of foreign subsidiaries of U.S. corporations in major tax havens soared from \$88 billion in 1999 to \$149 billion in 2002. Profits in zero-tax Bermuda tripled over this short period.<sup>7</sup>

Increased avoidance – both overseas and domestically – has contributed to sending overall corporate tax revenue to historic lows. In 2003, corporate taxes were only 1.2 percent of GDP – their second lowest level as a share of our economy since 1934 (corporate

taxes were 1.1 percent of GDP in 1983).<sup>8</sup> In addition, the role of corporate revenue in meeting our overall revenue needs has fallen in the past four years.

### **Adequacy**

Finally, the tax cuts have resulted in bringing tax revenues to their lowest levels since 1959, at just 16.2 percent of GDP in 2004.<sup>9</sup> This dramatic decrease has resulted in record deficits. *It is unfair for today's policymakers to burden America's younger generation with the obligation of paying back such excessive borrowing in later years.*

While the president has charged the panel with formulating “revenue neutral options,” we hope that the panel would resist the call to choose a revenue baseline that assumes extensions of the 2001 and 2003 tax laws. The panel should emphasize the need to fully fund vital national priorities over the long-term, and to explicitly reject the notion that tax shortfalls and large deficits are a good political strategy to reduce overall spending levels.

Overall, the federal tax system has become increasingly reliant on the regressive payroll tax, has shifted the burden of tax payment from the wealthy to the middle class and has allowed corporations to avoid paying their fair share of taxes. The president's stated future goals for the tax system, including making the tax cuts permanent and eliminating taxes on capital gains and dividends, will only exacerbate the degree to which the system has become unfair.

## **Goals that the panel should try to achieve as it evaluates the existing tax system and recommends options for reform**

As a nation, we have established certain fundamental priorities: among them are protecting the safety, security and health of our citizens; ensuring the right to a world-class education; providing vital public services; and preserving the dignity and basic comfort of our elderly. We have realized throughout our country's history that supporting these priorities requires resources that no individual or small group of individuals could ever hope to raise by themselves. The challenge of tax policy is to generate these resources efficiently and in a way that is consistent with our values as a nation. Those values can be summarized by three basic principles for our tax code: *opportunity, fairness and simplicity*.

A successful tax code should encourage economic and job growth, continue to reward ingenuity and hard work, and expand the American middle class. We also need a tax system that raises revenue efficiently – that creates as few economic distortions as possible while still meeting our other national priorities.

Currently, large deficits are threatening our nation's ability to foster opportunity for all Americans. The last four years have seen record budget surpluses turned into massive budget deficits. This is a trend that must be reversed. A new tax code should be judged on its ability to raise adequate revenue to run the government without debilitating deficits.

While some maintain that cutting government spending is the only solution to unacceptable levels of budget deficits, ample evidence shows that the current deficit problem is one of inadequate revenue rather than excessive spending.

At the same time, our tax system has at its foundation a basic notion of fairness.

With the enactment of the Income Tax Law of 1913, the federal government applied the principle that taxes should be levied based upon ability to pay. This idea of “progressive” taxation grows from the belief that those who achieve the greatest wealth also benefit the most from what our nation provides. Our schools, the stability of our economy, and public investments in research and innovation all contribute to the successes of America. As Andrew Carnegie explained, “where wealth accrues honorably, the people are always silent partners.”

Finally, Americans have always valued a simple, streamlined role for government in their lives. Complexity in the tax code too often breeds waste and abuse, which erode the fairness and efficiency of our tax code. Tax complexity for both individuals and corporations can create “gray areas” in which some are able to take advantage in ways not foreseen by the code. This favors those wealthier individuals and corporations who can afford tax accountants and professional tax preparers to exploit holes in the system. The perceived unfairness of a complicated tax code can erode the faith people place in our public institutions, and can reduce overall compliance.

A serious tax proposal should be based on these realities. It should strive to raise adequate revenue for the government in as fair and simple a way as possible. At the same time, the goal of tax reform should not be to reduce revenues, as this will worsen the deficit and lead to serious economic distortions.

Comments submitted to the President's Advisory Panel On Federal Tax Reform  
Center for American Progress – March 18, 2005

## Sources

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<sup>1</sup> Office of Management and Budget, *Fiscal Year 2006 Budget of the U.S. Government*.

<sup>2</sup> Tax Reform Panel website, <http://taxreformpanel.gov/> (last viewed March 17, 2005).

<sup>3</sup> Joel Friedman, Robert Greenstein & Isaac Shapiro, Are Taxes Exceptionally Concentrated at the Top? Treasury Department Release Creates Misleading Impression about Taxes that High-Income Taxpayers Pay, Apr. 15, 2004, available at <http://www.cbpp.org/4-15-04tax.htm> (last viewed Jan. 6, 2005).

<sup>4</sup> Joint Economic Committee, Democratic Staff Report: New CBO Analysis Confirms That the Bush Tax Cuts are Skewed Toward the Rich, August 2004, available at <http://jec.senate.gov/democrats/Documents/Reports/CBOtaxcuts13aug2004.pdf> (last viewed Jan. 21, 2005)

<sup>5</sup> Tax Policy Center, Historical Percentage of Revenue by Source (2004), available at <http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=204> (last viewed Jan. 6, 2005)

<sup>6</sup> Citizens for Tax Justice, Bush Policies Drive a Surge in Corporate Tax Freeloading, Sept. 22, 2004, available at <http://www.ctj.org/corpfed04pr.pdf> (last viewed Jan. 6, 2005).

<sup>7</sup> Martin Sullivan, *Data Show a Dramatic Shift of Profits to Tax Havens*, *Tax Notes*, Sept. 13, 2004, at 1190.

<sup>8</sup> Isaac Shapiro, Federal Income Taxes, as a Share of GDP, Drop to Lowest Level Since 1942, According to Final Budget Data, Oct. 21, 2003, available at <http://www.cbpp.org/10-21-03tax.pdf> (last viewed Jan. 6, 2005)

<sup>9</sup> See Congressional Budget Office, The Budget and Economic Outlook: An Update, September 2004; and Center on Budget and Policy Priorities, Official Treasury Report Shows Fourth Year of Deficit Growth, Despite Economic Recovery, October 2004.